



Utah Department of Commerce

**Division of Securities**

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Protecting Investors. Regulating Industry. Promoting Commerce.

# Investment Adviser Workshop:

the New Form ADV Part 2, New Rules, and the IA Switch



# The SEC's 2010 Custody Rule: Changes and New Requirements

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Examiner



## Custody Rules

# Purpose

- Prevent loss, misuse, and misappropriation of clients' assets
- Encourage the use of an independent custodian
- Additional Requirements for:
  - Advisers with Custody or
  - Whose Related Person has Custody



## Custody Rules

# What Did Not Change

- Utah incorporated by reference the SEC custody rules
  - Utah Uniform Securities Act 61-1-2(3)
  - Utah Administrative Rule R164-6-1g(E)(15)
- SEC custody rules adopted in 2003
- Amended in 2009, became effective March 12, 2010



## Custody Rules

# What is New

- Annual Surprise Examinations  
(independent verification)
- Internal Control Reports
- Client / Custodial Statements



# Custody Rules Definition

## **CUSTODY:**

Adviser or its related person holds, directly or indirectly, client funds or securities, or has any authority to obtain possession of them.



## Custody Rules

# Direct Custody

- Possession of client funds or securities
- Permission to withdraw client funds or securities upon Adviser's instruction (including a general power of attorney)
- Legal ownership capacity or access to client funds or securities (GP of limited partnership, managing member of LLC, equivalent position pooled investment vehicles, trustee of trust)



## Custody Rules

# Indirect Custody

- Advisers that receive client checks written to a third party but fail to forward to the third party in a timely fashion.
- Limited power of authority to transfer funds or securities
- Direct Deduction of Advisory Fees



## Custody Rules

# Definition

### **RELATED PERSON:**

Any person, directly or indirectly, controlling or controlled by IA, and any person that is under common control with the IA (may include banks and broker-dealers).



## Custody Rules

# Definition

### CONTROL:

- The power to directly or indirectly control, manage or set policies of the IA
- Officers, partners, directors, LLC manager, trustee, managing agent, other persons with management control
- Presumption control – ownership  $> 25\%$



## Custody Rules

# Definition

### **QUALIFIED CUSTODIAN (QC):**

- Bank, savings association, registered broker-dealer, registered futures commission merchant
- QC maintains client funds and securities
  - (i) in a separate account for each client under such client's name; or
  - (ii) in accounts that contain only client funds and securities, under the IA's name as agent or trustee for the clients



## Custody Rules

# Annual Surprise Exam

### SCOPE OF THE EXAM

“...verify clients funds and securities of which an adviser has custody, including those maintained with a qualified custodian and those that are not required to be maintained with a qualified custodian, such as privately offered securities and mutual fund shares.”

Footnote: 36 SEC Custody Rule Adopting Release IA-2968.



## Custody Rules

# Annual Surprise Exam

If the adviser or related person has custody:

- Independent verification of client funds and securities by actual examination
- At least once during each calendar year
- Exam date chosen by accountant
- Unannounced with no advance notice
- Irregular from year to year



# Custody Rules Engagement

Advisers must enter into a written contract

- Independent Auditor
- PCAOB registration - Public Company Accounting Oversight Board
- Subject to PCAOB review
- Contract must state the exam will start by December 31, 2010, or 6 months after becoming subject to requirement



## Custody Rules

# Engagement

- Financial statements U.S. GAAP/ Audit conducted pursuant to U.S. GAAS
- Auditor must agree to inform Utah within one business day of discovery of a material discrepancy
- Auditor must file within four business days a statement regarding the auditor's termination along with a hard copy of the Form ADV-E



## Custody Rules

# Finding an Auditor

- Website: *pcaobus.org*
- PDF list
- Searchable database
- Export Excel list



## Custody Rules

# Internal Control Report

If the adviser has custody or adviser's related person has custody (is a qualified custodian), then the independent auditor performing the surprise exam must be engaged to prepare a written internal control report of the related person QC



## Custody Rules

# Internal Control Report

- Auditor's Opinion states whether:
  - Controls have been placed in operation as of a specific date
  - Controls are suitably designed
  - Controls are operating effectively to meet control objectives of custodial services, including safeguarding of client funds



## Custody Rules

# Internal Control Report

- Independent auditor must verify funds and securities are reconciled to a custodian other than the Adviser or their related person
- Independent auditor is PCAOB registered
- Report within 6 months of becoming subject to the rule and annually thereafter



# Custody Rules Summary

Custodial Conditions	Surprise Examination	Internal Control Report
Fee Deduction Only	NO	NO
“Enhanced” Custody, but QC ≠ Related Person and No Common Ownership	YES	NO
“Enhanced” Custody and QC = Related/Affiliated or Has Common Ownership	YES	YES
Physical Custody	YES	YES
Pooled Investment Vehicles (PIVs) or other types of investment funds	Since these can be organized in many ways, each model will need to be evaluated independently. Please contact the Division to discuss the requirements for these funds.	



# Custody Rules

## QC Statements

- Initial Notice to Clients
- Account opened with QC, prompt, written notification to clients
- QC name, address, & how funds/securities are maintained
- Prompt written notification of any changes
- If Adviser sends his own statements in addition to QC, notification must urge clients to compare adviser's statements to QC



# Custody Rules

## QC Statements

- Advisers must have a reasonable basis, after due inquiry, for believing the qualified custodian sends at least quarterly statements to clients
- Statements sent *directly* from a QC to client
- Statements must identify the amount of funds and securities held for client and all transactions in the account during the period
- Insufficient to merely confirm that statements are available to client



# Custody Rules

## Books and Records

- Auditor's surprise examination agreement
- Auditor's signed & finalized report
- Internal control report
- QC account opening notices
- QC client statement due inquiry workpapers
- Keep 5 years



# Custody Rules Policies and Procedures

Adopt and implement written policies and procedures reasonably designed to prevent violations and provide for supervision of IA's representatives.



## Custody Rules

# Compliance Dates (SEC)

## **SURPRISE EXAM**

- CPA engagement letter (written agreement) on or before December 31, 2010
- Exam complete and auditor certification with 120 days after the exam begins
- Exam must be within 6 months of becoming subject to the rule



## Custody Rules

# Compliance Dates (SEC)

## INTERNAL CONTROL REPORT

- 6 Months after Effective Date  
(Sept 2010)
- 6 months after becoming subject  
to the rule



## Custody Rules

# Compliance Dates (SEC)

### **POOLED INVESTMENT VEHICLE AUDITS**

- Non fund of funds: “reasonable belief” that audited financials will be distributed to investors within 120 days of the pool’s FYE
- Fund of funds: 180 days after pool’s FYE
- ADV: new disclosures must be in the first annual amendment filed after Jan. 1, 2011.



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